No. 12433

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

First National Benefit Society, a corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S REPLY BRIEF.

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Statement.

We believe that Respondent has correctly stated the jurisdictions and the questions presented in this case.

We agree with Respondent's statement on page 3 of his brief that during the year 1939, the one herein involved, Petitioner was engaged in business under the provisions of Section 53-601 to Sections 53-622, inclusive, 1939 Ariz. Code Anno.

Respondent in his statement (p. 3 of his brief) after setting out the finding of the Tax Court in the above language quoted the Tax Court as follows (taken from the Articles of Incorporation of the Petitioner):

> "That the objects and purposes for which said Corporation is formed are: To engage in, conduct and carry on the business and customary activities of a mutual benefit association within the meaning and provisions of Sections 607-608-609-610 of Chapter 14 of Article 3 of the 1928 Revised Statutes of the State of Arizona as the same now exists; * * *"

The Constitution of the State of Arizona providing for incorporation under general laws reserves the right to alter amend or change the laws in regard thereto at any time. (Art. 14, Sec. 2, Ariz Const.)

These laws were amended, effective late in 1937 providing for entirely different set up in regard to reserves of such companies, and requiring all such companies to qualify under the new law if they were to remain in business, and the Tax Court actually found and indeed it was stipulated herein that Petitioner was during the year 1939, operating under the 1937 statutes. [R. p. 51.]

The 1937 Law, Section 16, Article 3, Chapter 14, Revised Code of 1928, was amended by adding Section 610a, which is 53-616, 1939 Arizona Code Annotated (p. 11, Appendix to Op. Br.), and reads as follows:

> "610a. EXISTING CORPORATIONS. Any existing Corporations under the provisions of sections 607, 608, 609 and 610, article 3, chapter 14, Revised Code of 1928, shall be deemed to be lawfully incorporated, organized and existing and may continue its corporate existence and transact business under, and avail itself of the provisions hereof without reincorporating or requalifying, except that such corporation shall, on or before January 1, 1938, comply with the provisions hereof as to statutory agent, minimum membership, deposits of money or securities, benefit certificate, fidelity bond, and certificate of authority, and shall be subject to examination as herein provided. (Now section 53-616, A. C. 1939.)"

An entirely new law in regard to Mutual Benefit Societies was enacted in the 1937 statutes and the corporations already operating were merely given the right to qualify under the new law without reincorporating.

Argument.

I.

Under Topic I, Respondent states that the taxpayer was not a life insurance company in the taxable year within the meaning of Section 201(a) of the Internal Revenue Code.

Under sub-topic A thereof, he asserts that this Court has twice held that a taxpayer is not a life insurance company within statutory provisions identical with section 201 of the Internal Revenue Code, and cites two former cases involving the First National Benefit Society. First of these cases is, *First National Benefit Society v. Stuart,* 134 F. 2d 438, involved the years 1936 and 1937. During which time an entirely different law was in effect in the State of Arizona, a law which made no provision for reserves, deposits, examinations or supervision. The 1937 law did not go into effect until late in 1937, so that these years were not controlled by the 1937 law. In *First National Benefit Society v. Stuart,* 152 F. 2d 298, involving the year 1938 this Court did not affirmatively hold that the taxpayer was not a life insurance company, but stated that the taxpayer had not borne the burden of proof to show that it was a life insurance company, and did not state wherein the taxpayer had failed in that proof. Further the question as to whether or not the taxpayer is an assessment life insurance company was not raised heretofore.

In Sub-Topic B, Respondent sets out the definition of a life insurance company under Section 201 of the Internal Revenue Act, and under this topic he sets out the various classifications of insurance companies under the code. However, it is apparent under these sections that

Congress has never attempted to distinguish between two types of life insurance companies. Respondent has pointed out that the type of life insurance company provided for under the provisions, under which taxpayer is operating are not a part of the general insurance laws of the state. We wish to add that neither are fraternal insurance companies provided for under the general insurance law, and that they when they are engaged in a life insurance business, without argument by Respondent held to be life insurance companies. It should be noted also that the general insurance laws of the State of Arizona and other states provide not only for life insurance companies but many other types of insurance companies, so that the mere fact that a taxpayer is a corporation provided for under the general insurance laws has nothing to do with whether or not it is a life insurance company.

On page 17, under the same topic, Respondent quotes from the case of *Helvering v. Inter-Mountain Life Ins. Co.*, 294 U. S. 686, 690. This case did not have under consideration the matter of classification of life insurance companies at all, but the question of a deduction allowed to life insurance companies out of interest earnings. This case is merely to the effect that reserves held for the liquidation of accrued endowment coupons was not a part of its insurance reserves. The last sentence of this case quoted by Respondent reads as follows:

> "In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the life insurance elements of the policy contracts."

but if Respondent had continued with the quotation, he would have found the following:

> "The premiums include enough over and above what is needed to maintain proper insurance reserves, to provide for the discharge of coupon liability according to the terms of the policy. The coupon values are the equivalent of cash and may be used to pay premiums on the face amount of the policy, to procure additional insurance to lessen the number of annual premiums or otherwise to obtain insurance protection. The amounts so applied cease to exist as coupon liabilities and automatically become a part of the life insurance reserves. They differ essentially from coupon liability. Life Insurance matures only upon death of the insured and the reserve is based upon that contingency whereas the liability on the matured coupons depends upon no contingency. It follows that the insuring reserves alone constitute the base on which the deduction is to be computed. Reserves against matured coupons are excluded."

In other words the Court in this decision as in all other decisions we have read is not attempting to set up or require a standard for monetary valuation of a policy, which would be of value to a regulatory statute, but to distinguish between the endowment, investment, or other features of a policy and the insurance element. That is, only those reserves which are held against the contingency of death or life insurance reserves, since that contingency grows greater year by year. Respondent's argument to the effect that taxpayer did not maintain the reserve contemplated by Congress for the reason that it was not deposited in a separate bank account is again an attempt to place a regulatory intention on the part of Congress rather than a classification for taxation purposes.

The accounting practice of practically all companies recognized by Respondent as life insurance companies is identical with that of taxpayer, and that the only segregation of reserves is upon the books of the corporation.

In his work of life insurance accounts E. C. Wightman Second Edition in Chapter 4, makes the following statement:

> "The only item which appears upon the liability statement which can be taken from the accounts within the bookkeeping system is the amount of paid-up Capital. All of the other liability items are obtained either from memorandum accounts or through inventory methods. It should be noted that liabilities which are secured by the pledge of specific assets appear in the Annual Statement as deductions from the assets rather than as liabilities. Inasmuch also as all debits and credits to agents' accounts are controlled through a single general ledger account without regard to whether such accounts may show a debit or a credit balance on any specific date, the total of those accounts which do show a credit balance as of the date of the Annual Statement and which are really liabilities is reported on the assets statement as a deduction from the total of those accounts which show a debit balance at that time."

It should be borne in mind that the Petitioner set up its reserves by daily placing in a mortuary account those funds required by the law to be placed in its mortuary fund and which were designated on the books of the corporation as assessments [Exhibit 4 attached to the Stipulation on file herein] and [Exhibit 6 attached to the Stipulation], also that the funds set aside as mortuary funds by Petitioner have never been used for any purpose but that of paying death claims, but as a matter of fact expense funds were

many times transferred to the mortuary fund and used to pay death claims. [R. p. 53.]

In Sub-Topic C, of Respondent's Brief, Respondent's contention is that since the interest earned on the deposit with the State could be used for ordinary running expenses, that the deposit itself could not be regarded as a reserve required by law. The law here referred to does actually require that this reserve be set aside for the liquidation of its contracts, and has been so interpreted by the Arizona Supreme Court in *Pioneer Mutual Benefit Society v. Corporation Commission,* 123 P. 2d 828.

In Sub-Topic D, beginning on page 21 of his brief Respondent has taken the position evidently that only a "legal reserve" was contemplated by Congress in the enactment of Section 201 of the Internal Revenue Act. If either Congress in enacting the law or the Treasury Department in promulgating its regulations had set out the term "legal reserve" then that simple term would have disposed of all argument, but neither the statutes nor the regulations uses this term. The term "legal reserve" is the one applied to a bookkeeping system wherein a separate reserve is set up for each individual policy as against a tabular reserve which is a reserve against the insurer's total contingent liability. The only way in which the term "legal reserve" could be applied under the code, the decisions, or the regulations involved herein, is that they be reserves required by the law of the state in which the insurer is operating. The regulations themselves (Treasury Regulation 103, Sec. 19.203(a)(2)-1) read in part as follows:

> "Sec. 19.203(a)(2)-1. Reserve funds.—In general, the reserve contemplated is a sum of money, variously

> computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims."

This is the only requirement by either the code or the regulations as to the form of the required reserves. Respondent further continues on page 22 of his brief that the cases which he cites do not disapprove the regulations.

After contending that the reserves required by the Arizona statutes are subject to certain defects in the statutory requirements, Respondent on the bottom of page 23 of his brief says:

> "As already noted, since taxpayer has not proved the existence of any reserve fund at all, on the language of the statute alone without taking into consideration the Regulations, the decision below was correct."

This statement we do not understand, since the Arizona law, Section 53-609, 1939 Arizona Code Annotated (p. 7, Appendix to Op. Br.), provides and requires the setting aside of a Mortuary Reserve Fund and since this statute has been construed in the *Pioneer Mutual Benefit Society v. Corporation Commission,* 123 P. 2d 828, to authorize the State Insurance Commissioner's requirements of the amounts that must be set up in said reserves, and since said reserve was actually set aside for the purpose of paying death claims, and since no other item ever was charged to the mortuary fund of the taxpayer, except the payment of income taxes after the Commissioner

had threatened to seize, and which was thereafter replaced. It appears to us that Respondent's approach to this question is one which regards the law and the Regulations of the Treasury Department as setting up certain requirements in regard to reserves which the laws of the various states must conform to in order that the insurer organized and operating thereunder may obtain some special privilege granted by Congress in regard to income taxation.

We believe that the proper approach is one that regards both the law and the regulations as setting up distinctions between different types of insurance business based upon the character of the business actually transacted by the insurer. We believe that no purpose would be served in rehashing the history of this legislation which was enacted as a result of the successful contention by the insurance companies that level rate premiums covering an increasing liability from year to year must build up in the earlier years a reserve against that increased liability, and that the sums accumulated in the earlier years against a contingency which is sure to happen, is not income but rather a contribution to assets. At any rate regardless of intent, the actual result is that any other life insurance company, except a legal reserve company or post mortem assessment company is by this statute prohibited from doing business for no insurance company can pay an income tax of from 16 to 38 per cent of the addition to its reserves, and stay in business when its competitors do not pay this tax.

II.

In his first paragraph under the above number on page 24 of his brief Respondent contends that if the taxpayer is to be classified under Section 207, it is still not entitled to a deduction for additions required by law within the taxable year to reserve funds within the meaning of Section 207(c)(1)(A) in the sum of $4,518.71. Respondent appears to believe that it is Petitioner's contention that it would be entitled to such deduction because it is an assessment company. We did not mean to leave this impression. Our contention that Petitioner is an assessment life insurance company we believe should classify it under Section 201. And this classification we believe depends upon whether or not the ordinary term of assessment life insurance should be used which includes even stipulated premiums of assessments paid in advance subject to further assessment if necessary or whether the term is to be limited as Respondent contends to post mortem assessment companies now almost non-existent.

It is our contention that Petitioner is entitled to a deduction under the above subsection of Section 207 of the amount deposited with the State Treasurer of the State of Arizona, during the year 1939, since the same was required by law to be so deposited, and since if the company should be classified under 207, the term "legal reserve" could not be intended or a similar reserve for the reason that if classified under 207, the Petitioner (in spite of the fact that its business is actually life insurance), that therefore the defects in such life insurance reserves surely could not be urged under such a classification. We cannot believe that Respondent actually contends that the addition referred to under this subsection is the same type of reserve as that required for classification under Sec-

tion 201 of the code, and yet it is our understanding from Counsel's contention that the deduction cannot be allowed because the reserves provided for under this subsection of 207 do not conform to what he regards as the requirements for classification under 201 of the Code. How can it be contended as Respondent states on page 25 of his brief, that Petitioner's Mortuary Reserves are reserves held for the ordinary running expenses of its business.

At the risk of seeming to repeat, it appears from Counsel's argument that Respondent's contention is that Petitioner is not entitled to be classified as a life insurance company because its reserves are not the type of reserves contemplated by the law to be classified as such a company, and that Petitioner should therefore be classified as an insurance company other than life under Section 207, so that it is not entitled to a deduction provided for under 207 because its reserves are not the type contemplated by Section 207, for the reason that they are not the reserves contemplated by Section 201.

III.

Under this number on page 26 of its brief, Respondent appears to take the position that Petitioner had abandoned his claim for deduction under Section 207(c)(3) of the Internal Revenue Code, which provides for a deduction of money held out of premium deposits either returned to the policyholders or retained for the payment of losses, expenses and reinsurance reserves. The Tax Court likewise appeared to believe that Petitioner had abandoned this contention, but Petitioner has never done so. In order to deprive Petitioner of this deduction the term "retained for payment of losses" would have to be interpreted to mean "retained for payment of *accrued* losses."

In *American Ins. Co. of Texas v. Thomas,* 146 F. 2d 434, the United States Court of Appeals for the 5th Circuit had before it the matter of classifying an insurance company for taxation purposes. The Court never actually classified the insurer under any section, but held that the funds placed in a reserve against the fulfillment of future claims was not income. In making this decision the Court said:

> "It could hardly be maintained that a premium was entirely earned if there yet remained something to be done in later years by the insurer as a part of the consideration of its receipt. The State of Texas has determined that seventy per cent of the premiums should be placed in an inviolable fund for the fulfillment in the future of the insurer's obligation to be insured, and the premium is not entirely earned until the obligation is fulfilled.
>
> "So much of the premiums as go into such fund and remain therein after the paying of all losses and charges against said fund could not be characterized as earned premium or as net underwriting income, nor could it be characterized as net investment income under Sec. 204.
>
> "Whatever part of the taxed sums as were derived from insurance premiums and were a part of the increase in the Mortuary Fund of Appellant should have been held to be unearned premiums and deductible from the underwriting income even though the Appellant was not a mutual insurance company."

We submit therefore, that the Petitioner is a life insurance company, and that if it is not a life insurance company, but rather an insurance company other than life under Section 207 of the Internal Revenue Code it is entitled to the deductions provided for in said section without the requirement that its reserves be those contemplated under Section 201, and that in all events the money accumulated in a reserve fund by Petitioner to fulfill its future obligations which were placed upon its books at the time its policies were written, is not income, but held in trust for its policyholders, and that the decision of the lower Court herein should be reversed.

Respectfully submitted,

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